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No. 94, Original

IN THE

# Supreme Court of the United States

October Term, 1987

STATE OF SOUTH CAROLINA,
*Plaintiff,*

NATIONAL GOVERNORS' ASSOCIATION,
*Plaintiff-in-Intervention,*

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,
*Defendant.*

## MOTION OF THE NATIONAL GOVERNORS' ASSOCIATION FOR LEAVE TO FILE REPLY BRIEF AND REPLY BRIEF

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August 21, 1987

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## MOTION OF THE NATIONAL GOVERNORS' ASSOCIATION FOR LEAVE TO FILE REPLY BRIEF

The National Governors' Association ("NGA"), plaintiff-in-intervention, respectfully requests that this Court grant it leave to file a Brief in Reply to the Defendant's Brief in Support of the Report of the Special Master. Because the defendant Secretary of the Treasury declined to file exceptions to the Report of the Special Master, a reply brief will afford the NGA its only opportunity to respond to the Secretary's arguments before this Court.

On February 23, 1987, the Court instructed each of the parties to file any exceptions to the Special Master's Report, with supporting briefs, within 45 days. The parties then were permitted to file reply briefs 30 days later. On May 9, 1987, pursuant to an

extension granted by this Court, the NGA duly filed its exceptions to the Report of the Special Master. The Solicitor General, however, notified this Court that no exceptions would be filed on behalf of the Secretary of the Treasury.

On July 10, 1987, pursuant to a second extension of time granted by the Court, the Solicitor General, on behalf of the Secretary of the Treasury, filed a brief in response to the NGA's exceptions. Because the Secretary had not filed exceptions with a supporting brief, the NGA could not reply at that time. Accordingly, the NGA respectfully requests this Court now grant it the opportunity to file a brief in reply to the Secretary.

For the foregoing reason, the NGA respectfully requests this Court grant it leave to file its Reply Brief.

Respectfully submitted,

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## REPLY BRIEF OF THE NATIONAL GOVERNORS' ASSOCIATION

Plaintiff-in-intervention National Governors' Association (the "NGA") and defendant Secretary of the Treasury (the "Secretary") apparently agree on the proper standards that should guide resolution by the Court of this dispute. In fact, the Secretary's brief in support of the Report of the Special Master makes clear that the only area of substantial disagreement between the Secretary and the NGA concerns application of the appropriate standards to the facts of this case. Before addressing that disagreement, it is useful to summarize the common ground between us.

1. The NGA and the Secretary agree that Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324, 595, 26 U.S.C. § 103(j) (1982) ("TEFRA") properly is evaluated under Tenth Amendment principles as a direct regulation of the States, and that this Court need not address the intergovernmental tax immunity issue also presented in the original complaint. (Sec'y Br. 38-39; NGA Br. 24.) Section 310(b)(1) on its face does not command compliance, but instead appears to offer a choice, conditioning the federal tax exemption on state and local debt upon registration of that debt.* The Special Master found as a fact, however, that conditional loss of the tax exemption would have consequences so harsh that the clear intent of Congress and the effect of the statute was not to present a choice, but to mandate registration of municipal debt. (Report at 2.) Thus, the Secretary and the NGA believe that Section 310(b)(1) properly is viewed as a direct regulation of the States, and that this Court need only, and should only, address the Tenth Amendment issue. (Sec'y Br. 24; NGA Br. 24.)

2. Next, the NGA and the Secretary are in agreement that although this Court's decision in *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528 (1985), "altered the landscape of federalism jurisprudence," (Report at 117), that decision did not hold that in the future this Court would

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* Because on its face Section 310(b)(1) does not mandate compliance but seeks to obtain compliance by using loss of the tax exemption as a sanction, plaintiff State of South Carolina challenges Section 310(b)(1) under the intergovernmental tax immunity doctrine. Although the NGA (as does the Secretary) believes that issue is not raised under the facts of this case, if the Court should choose to address the intergovernmental tax immunity issue, the NGA fully supports the merits position of the State of South Carolina that the tax exemption is constitutionally compelled.

refuse altogether to review state challenges to federal enactments. (Sec'y Br. 27; NGA Br. 28.) At earlier stages in this litigation the Secretary seemed to suggest that *Garcia* signalled a complete abdication by this Court of its responsibility to referee disputes between the federal and state governments. (Sec'y Pretrial Mem. 3.) That interpretation of *Garcia* would be inconsistent, however, with the grant of original jurisdiction to this Court,* with this Court's historic role in the constitutional system, *Marbury v. Madison*, 5 U.S. (1 Cranch) 137 (1803), and with the Court's most recent precedent, *South Dakota v. Dole*, No. 86-260 (June 23, 1987) (resolving on merits state challenge to federal enactment).

The NGA and the Secretary both recognize, however, that although this Court has the authority and responsibility to review state challenges to federal enactments, the Court should not lightly or frequently strike such enactments. Rather, the NGA and the Secretary agree that this Court should overturn a federal law regulating the States only in the "extraordinary" or rare case. (Sec'y Br. 27; NGA Br. 29.) This requires defining the circumstances that are so extraordinary as to require judicial intervention to invalidate a federal regulation.

3. The NGA and the Secretary apparently also are in agreement as to the standards that distinguish the extraordinary case where Congress has surpassed constitutional bounds from the case where it has not. The relevant inquiry is whether the challenged federal law amounts to an invalid co-option by the federal Congress of state and local regulatory machinery to further federal ends. (Sec'y Br. 21; NGA

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* *See South Carolina v. Regan*, 465 U.S. 367, 397 (1984) (O'Connor, J., concurring) ("[T]he Framers . . . thought that the original jurisdiction was a necessary substitute for the powers of war and diplomacy that these sovereigns previously had relied upon").

Br. 30, 35.) The test is taken directly from this Court's decision in *FERC v. Mississippi*, 456 U.S. 742 (1982), where the Court distinguished a generally-applicable federal regulation from the special problem raised in *FERC*:

> *National League of Cities*, like *Fry v. United States*, 421 U.S. 542 (1975), presented a problem the Court often confronts: the extent to which state sovereignty shields the States from generally applicable federal regulations. In PURPA, *in contrast, the Federal Government attempts to use state regulatory machinery to advance federal goals.*

*FERC v. Mississippi*, 456 U.S. at 758-59 (emphasis added). *See also Bowen v. American Hosp. Ass'n*, No. 84-1529 (June 9, 1986) (plurality opinion), slip op. at 30 n.29 (quoting *FERC v. Mississippi*, 456 U.S. at 783 (O'Connor, J.) (dissenting in part, concurring in part) ("Important principles of federalism are implicated by any 'federal program that compels state agencies . . . to function as bureaucratic puppets of the Federal Government'").

The Secretary's brief suggests that the NGA is asking this Court to apply different standards than those suggested by *FERC*, encompassing not just the co-option of state regulatory machinery but any federal regulation that has the "incidental"* effect of requiring state governmental

* When the Secretary refers to "incidental" effects of federal regulation, he apparently is referring not to some quantitative measure of how burdensome compliance with a federal regulation may be to state government, but simply is using "incidental" as shorthand to refer to a requirement imposed by a generally-applicable regulation. Any quantitative burden test would engage the Court in drawing lines at least as difficult as those required under the abandoned *National League of Cities* test. *See National League of Cities* v. *Usery*, 426 U.S. 833 (1976).

processes to bring state government into compliance. (Sec'y Br. 34-38.) This description of the NGA's test is overbroad, missing the crucial distinction between the state as regulated entity, and the state as regulator.* When Congress pursues its own regulatory ends, it may require compliance by state and local governments as well as by private entities. Compliance by state and local governments with "generally-applicable" regulations of the sort distinguished in *FERC* simply is the cost to the state government of doing business in the federal system. Invalidating all federal enactments that required any state action not only would call into question sound precedent

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* A simple example will suffice to make clear the relevant distinction. Suppose Congress wanted to ensure that all automobiles maintained a certain fuel efficiency. Pursuant to its commerce power, Congress could obtain this regulatory end directly in any number of ways, including regulation of automobile owners that might include periodic inspection. If Congress enacted this legislation, a state government that owned automobiles legitimately would be subject to the law on the same terms as a private entity that owned an automobile. But Congress could not pass a law requiring state governments to establish their own state regulatory programs to achieve the federal goal. That would denigrate the notion of separate and independent state governments, make the State a mere administrative tool of the federal government, and impermissibly divert the State from its own pressing agenda. *Cf. Bowen v. American Hosp. Ass'n*, No. 84-1529 (June 9, 1986) (plurality opinion), slip op. at 28 (regulations promulgated by the Secretary of Health and Human Services invalid, in part because they attempted to set investigative and enforcement priorities for state governments, diverting resources from other pressing programs).

Congress could, of course, provide federal funds to the States, and ask the States, in an exercise of cooperative federalism, to administer the program. That would be a valid approach under Congress' spending power. The critical difference is that the States would have a meaningful choice of whether to participate or not, *see South Dakota v. Dole*, No. 86-260 (June 23, 1987), and would receive federal monies to fund the project.

of this Court, but would unduly hamstring valid regulatory efforts of the national government.

Contrary to the Secretary's assertion, then, the NGA does not take the broad position that *any* enactment requiring some state response is invalid, but relies upon precisely the distinction offered in *FERC*, and adopted by the Secretary in his brief. A federal enactment is invalid if it co-opts state regulatory power to achieve a federal end.* Thus, as with much else, the NGA and the Secretary are in agreement as to the relevant standards that apply in this case.**

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* The NGA's main brief set out at length the theoretical and practical importance of proscribing the Congress from commandeering state and local government regulatory machinery to federal ends, as well as the importance of the rule in constitutional jurisprudence. The citizens who ratified the Constitution clearly anticipated that they were establishing two separate governments, a national government of limited powers against a backdrop of separate state governments with independent regulatory authority. (NGA Br. 31.) The national government was free to pursue its own regulatory agenda, and even could preempt state activity in federal areas. (NGA Br. 31.) No matter how broad federal regulatory authority has become, however, it remains interstitial by nature. (NGA Br. 32.) State governments must be left free to pursue their own critical agendas. (NGA Br. 33.) When federal laws usurp state regulatory authority to federal ends, state citizens are deprived of the focus of two separate and independent sovereigns that is "the special mark of American federalism." (NGA Br. 32.)

** The NGA and the Secretary are, with one important exception, also in agreement that the findings of the Special Master should be adopted by this Court. The exception is the Master's finding that no interest rate differential exists between bearer and registered bonds. The error in the Master's finding is failing to take account of the Secretary's own comprehensive and expansive economic study, which showed a differential of roughly 8 basis points. After his study was corrected and the result favored the NGA, the Secretary tried to disavow the study. The NGA believes, however, that the record amply supports the fact that a differential does exist. (NGA Br. 13-15.)

4. Apparently the only area of substantial disagreement between the Secretary and the NGA involves application of the *FERC* distinction to the facts of this case. The NGA maintains that Section 310(b)(1) impermissibly makes use of state and local regulatory machinery to accomplish the federal end. The Secretary disagrees, asserting that Section 310(b)(1) is a valid generally-applicable regulation.

The basis for the Secretary's position apparently is that because Congress required the federal government and private businesses to register their debt simultaneously with its imposition of the registration requirement upon the States, Section 310(b)(1) is, by its terms, "generally-applicable."* Even if this were correct as a factual matter,** however,

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* The Secretary also argues that because Section 310(b)(1) would be valid under *National League of Cities* it is *a fortiorari* valid after *Garcia*. It is difficult to see the relevance of this argument. The NGA's Tenth Amendment theory is derived from *FERC*, not from the *National League of Cities/Garcia* line of cases. The Secretary himself has acknowledged that the principles underlying those cases are very different. Moreover, the difference is one of nature, not of degree. Although a generally-applicable regulation might have survived scrutiny under *National League of Cities* and thus inevitably would be valid after *Garcia*, that offers no insight into the validity or invalidity of a federal enactment such as Section 310(b)(1) that commandeers state regulatory authority to further a federal end and thus raises questions under the different principles at issue in *FERC*.

** Plaintiffs maintain it is not. "Most corporate and Treasury securities had been shifted to registered form well before TEFRA was enacted, and *municipal bonds were thus the only category of bonds* that were still issued largely in bearer form at that time." (Secr'y Br. 20 n.15 (citing Tr. 1211-12, 1216, 1223-26, 1245-50, 1255-57) (emphasis added).) Corporate issuers and the United States shifted to registration because of market efficiencies (Secr'y Br. 5) that state and local issuers did not believe would accrue to them in the very different municipal market. Thus, as a practical matter, state and local issuers were the only ones forced to respond to a federal mandate to issue their bonds in registered form.

Congress nonetheless co-opted the regulatory machinery of the States to accomplish a federal end.

Congress, in enacting Section 310(b)(1), did not have some intrinsic interest in seeing to it that bonds were registered. Rather, Congress apparently hoped to stem a perceived use of bearer bonds to evade federal taxes. (Report at 83-84.) The end Congress had in mind, therefore, was the federal goal of reducing federal tax evasion.*

Congress had ample federal regulatory power available to attack the perceived tax compliance problem without demanding that the States use their regulatory authority to solve the problem. As a regulation in aid of its taxing power, *see M'Culloch v. Maryland*, 17 U.S. (4 Wheat) 316 (1819), Congress could have required all bond transfers to go through brokers in order for the bonds to retain negotiability, or Congress could have required that all bonds be deposited in a central bond depository such as The Depository Trust Company. Either of these would have been more effective tax compliance measures than was registration.**

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* Even after the extensive proceedings in this case the record is devoid of any evidence concerning either the extent to which bearer municipal bonds created a tax compliance problem or the extent to which registration addresses that compliance problem. (Report at 84.) Congress' own revenue figures fail to indicate any increased revenue from registration (*id.*), and the Secretary offered no evidence at trial as to the extent of the compliance problem or the revenue benefit of registration. (*Id.*) In sharp contrast, the NGA made a strong case that whatever the extent of the bearer compliance problem, registration does little to address it. The Master conceded the NGA's argument and proof had "some force," (Report at 85), and that "there are limitations to the utility of the registration requirement as an aid to tax enforcement" (Report at 88), but nonetheless deferred to Congress' judgment that there was a compliance problem and registration would address it.

** A broker transfer requirement would have been more effective because brokers currently have the obligation to file information reports with the Internal Revenue Service concerning all bond transactions.

Instead of pursuing these alternatives, both of which were well within federal regulatory grasp, the federal government mandated that the States establish an ongoing regulatory scheme to address the federal problem. State and local bond issuers would be required to monitor bond ownership in case federal agents decided at some point in time to make use of the information. In effect, the States were required to administer a program that keeps records of bond transfers on a daily basis.

Compliance was no simple matter for state government. The States were required to change numerous state laws to permit registration. (Report at 36-38; NGA Br. 9-11.) Significant state administrative resources were redirected merely to establish the regulatory program. (Report at 39-44; NGA Br. 11-12.) Moreover, for the life of each bond issue, state and local issuers must maintain a means of recording bond transfers and responding to Internal Revenue Service inquiries upon request. (Report at 81; NGA Br. 18-19.) In short, state regulatory machinery was co-opted for a purely federal end — monitoring of bond ownership to assist federal tax collection efforts — although the federal government easily could have achieved federal tax compliance goals more effectively with a federal regulatory program.

Seen in this light, Section 310(b)(1) must fail because as a policy matter whether or not it is a generally-applicable

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(NGA Br. 19.) Registration transfer agents do not now have this responsibility (Report at 82), and there is serious question whether statutory authority exists to permit transfer agents to report. (NGA Br. 19.) A depository requirement would have been more effective because there simply would be no physical transfers of bonds. Congress believed relatively untraceable physical transfers of negotiable instruments caused a tax compliance problem. (NGA Br. 17.) But government witnesses conceded that even registered bonds are subject to physical transfer that might be difficult to track. (NGA Br. 18-20.)

regulation, it nonetheless falls within the category identified by the *FERC* Court of impermissible co-option of state regulatory machinery. *FERC* v. *Mississippi*, 456 U.S. at 758-59. Co-option exists when Congress determines that in lieu of establishing a federal regulatory program Congress simply will require the States to use state regulatory powers to achieve the federal purpose.* That is what Congress did in this case. It is impermissible because it distracts state government from the vital role of meeting state citizens' needs in order to meet a federal goal well within the grasp of the separate and independent power given to the federal government by the Constitution.

The Secretary's response, relying on *FERC*, is that Congress could have banned bearer bonds from interstate commerce, and so it could impose the "lesser" intrusion of asking the States to register their debt as a necessary and proper regulation in aid of the taxing powers. (Sec'y Br. 24.) This argument fails to take account of significant factual differences between this case and *FERC*.

*FERC* involved a challenge to the Public Utility Regulatory Policies Act of 1978 ("PURPA"), enacted by Congress in response to the "nationwide energy crisis" of the 1970's.**

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* Federal co-option of state regulatory machinery also jeopardizes the proper functioning of the political process. The political process functions properly when a legislature is accountable for the burdens it imposes upon regulated entities. When Congress turns to the States to enforce a federal command, the political accountability for a program is separated from the administration of the program. To a private regulated entity, it appears as though the state government is responsible for the regulation, although in fact it is the national Congress that properly should take responsibility for the regulation.

** As indicated in the NGA's main brief, in a situation where federal regulatory authority alone is insufficient to address a national emergency, Congress might be free in limited fashion to seek regulatory assistance from the States (NGA Br. 42-44.) Here, there was no suggestion federal

*See FERC*, 456 U.S. at 745. Among its other provisions, PURPA required States to "consider" the adoption and implementation of certain regulatory standards. This mandate to consider federal standards differed from Section 310(b)(1) in three critical respects. First, the mandate only was to *consider* federal standards, not adopt them. Second, if a State chose, it might avoid even this minimal intrusion by abandoning the field of energy regulation altogether. *Id.* at 764. Finally, in PURPA the federal government provided funds to mitigate the States' costs of compliance. *Id.* at 751 n.14. All told, rather than pre-empting state authority entirely, as Congress could have done under its commerce power, PURPA established a program of "co-operative federalism." *Id.* at 767 (quoting *Hodel v. Virginia Surface Mining & Recl. Ass'n*, 452 U.S. 264, 284 (1981)).

Section 310(b)(1) shares none of these "co-operative federalism" characteristics of *FERC*. Section 310(b)(1) presented an unavoidable federal mandate.* Moreover because the exercise of state sovereign power at issue under Section 310(b)(1) is not energy regulation, but involves the State's revenue raising authority used to fund critical state projects, Congress could not pre-empt that authority. Conversely, the States could not, as was as possible in *FERC*, "abandon the field" and thereby avoid the federal directive. Finally, unlike *FERC*, in Section 310(b)(1) Congress provided no federal funds to mitigate the regulatory burden, but

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power was insufficient; indeed, the federal government had adequate regulatory means to attack the problem on its own. *See supra* at 10-11.

* Under Section 310(b)(1) the States only could avoid registration by forfeiting the tax exemption. As indicated, *supra* at 4, the Special Master found this "choice" was illusory. (Report at 2.)

required the States to shoulder the entire load. In no sense, therefore, could Section 310(b)(1) properly be termed a "lesser" intrusion than direct federal regulation.

Congress' decision to eschew more effective federal regulatory means in favor of requiring the States to shoulder the burden of addressing a federal agenda item underscores the importance of this case. Increasingly Congress is stepping away from solving its own problems and asking the States to do federal work. Ironically, this occurs at a time when federal contributions to state government are diminishing in proportionate terms. The danger is that the States slowly will be diverted from state agendas and will become administrative federal units. Rather than establishing a program of "cooperative federalism," as *FERC* suggests is permissible, Section 310(b)(1) is a classic example of "co-optive federalism." The NGA respectfully requests that this Court sustain its challenge to the statute.

## CONCLUSION

For these reasons, and for the reasons stated in its main brief, the NGA requests that this Court find Section 310(b)(1) an unconstitutional exercise of Congress' power.

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